FRBSF Weekly Letter
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U.S. Banking Turnaround

A favorable interest rate environment and improved asset quality in 1992 combined to produce three consecutive record quarters of earnings for the nation's 11,590 commercial banks. The good news also has helped fuel a run-up in bank stock prices.

The turnaround in bank earnings nationally has been dramatic, and far more robust than the recovery experienced by the U.S. economy. After-tax profits of $24.1 billion over the first three quarters of 1992 pushed return on assets (ROA) at commercial banks to 0.94 percent (annual rate), an excellent level for the industry. The 1992 performance of banks contrasts sharply with that of 1991, when they were heavily burdened by problem loans and ROA was a moderate 0.59 percent.

Furthermore, the turnaround has been widespread. The percentage of banks reporting losses during the first three quarters fell from 11.4 percent in 1991 to 6.5 percent in 1992. All regions of the country and all sizes of banks reported improved earnings, although bank performance in California continues to lag behind the recovery nationally.

The improved earnings were reflected in bank stock prices, which outperformed the overall market in 1992. The Salomon Brothers 50-bank stock index, for example, rose 29 percent last year, compared to the 4.4 percent increase in the S&P 500.

Asset quality improves

One factor contributing to the turnaround in bank earnings has been the reduction in troubled loans. The past due (30 days or more) and nonaccrual loan ratio for U.S. banks as a group began to come down in early 1991, and showed much improvement in 1992. The decline in the ratio reflects better asset quality in virtually all loan categories.

Improved asset quality boosted earnings, as banks were able to reduce their contributions to provisions for loan loss reserves. In the third quarter of 1992 alone, banks reduced their expenses for building loan loss provisions by $2.2 billion; for the first three quarters of 1992 these expenses were down by $4.3 billion from the prior year.

The steeply upward-sloping yield curve did even more for bank earnings by increasing net interest margins, the difference between the yield on assets and the cost of funding those assets. Wider margins have occurred as reductions in interest expenses for deposits and borrowings in 1992 exceeded declines in interest revenues on loans and securities and as banks relied more heavily on equity for funding.

The increase of 24 basis points in net interest margin for U.S. banks in 1992 boosted industry earnings by around $3 billion in the third quarter alone, and by over $8 billion for the first three quarters of 1992, with both large and small banks reporting wider margins.

Strong earnings and issuance of new equities have been key ingredients in the industry's efforts to build up capital positions. At the end of the third quarter of last year, equity-to-asset ratios for U.S. banks stood at 7.39 percent. That represents a 0.69 percentage point increase from a year ago. This increase in overall bank capital, along with higher asset quality, marks a real improvement in the condition of the banking industry.

California still lagging

In California aggregate bank performance also improved significantly in 1992, following losses in the third and fourth quarters of 1991. However, the performance of California banks still lags well behind that of the rest of the industry. The aggregate ROA figure for California banks was 0.60 percent for the first three quarters of 1992, up from a dismal 0.39 percent in 1991. In the first three quarters of 1992, 29 percent of the state's banks lost money, compared to only 6.5 percent nationally.

WESTERN BANKING *Western Banking* is a quarterly review of banking developments in the Twelfth Federal Reserve District. It is published in the *Weekly Letter* on the fourth Friday of January, April, July, and October.

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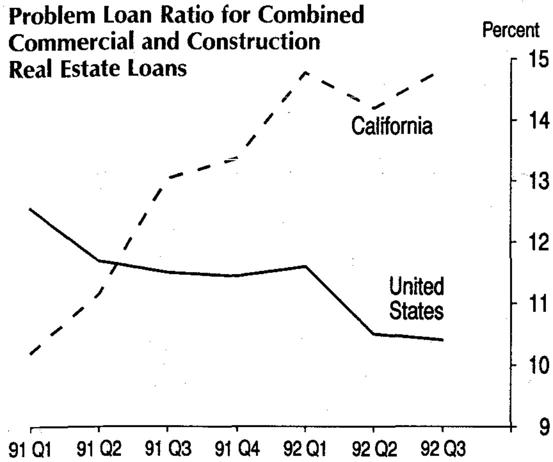
In California the performance of small banks (under $300 million in assets) deteriorated noticeably, as profitability fell in the third quarter of 1992. The problems were worse in the Southern California region, where small banks as a group actually lost money in the third quarter.

California banks' most stubborn problem continues to be real estate loans. As shown in Chart 1, at the end of the third quarter of 1992 California banks' problem loan ratio for commercial real estate and construction loans was 14.8 percent, compared to the 10.4 percent for the nation. Despite the improvement at the national level, loan quality for commercial real estate loans in California was still deteriorating.

Chart 1
Problem Loan Ratio for Combined Commercial and Construction Real Estate Loans



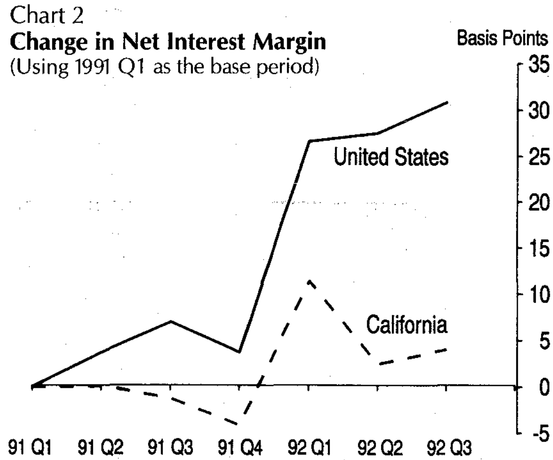
Within the commercial real estate loan category, problem construction loan ratios have risen nearly 900 basis points (nine percentage points) in California and problem commercial real estate loans have climbed by 300 basis points since the first quarter of 1991. In contrast, for U.S. banks as a group, problem construction and commercial real estate loan ratios have fallen by 130 and 146 basis points, respectively, as asset quality has improved. Moreover, California banks have a relatively high proportion of construction and commercial real estate loans in their loan portfolio, 24.8 percent of total domestic loans, compared to an 18.6 percent figure nationally.

Looking ahead

Continued high vacancy and foreclosure rates in California indicate that the commercial real estate problems with real estate loans will take time to resolve. The silver lining is that problem loan ratios for the state remain well below the levels that devastated the banking industry elsewhere, first in Texas and then in New England. Still, until a rebound is firmly underway in the California economy, it seems unlikely that the state's banks will experience the significant improvement in asset quality that they need to match the national performance of the industry.

In addition to more severe asset quality problems in California, the state's banks have not had the same widening in net interest margins experienced by banks nationally. As is shown in Chart 2, unlike banks nationally, California banks' net interest margins widened slightly in 1992. California banks' average yield on assets appears to have fallen more sharply than was the case elsewhere in the nation. Several factors likely contributed to the decline in California, including a larger portfolio shift from loans into lower-yielding securities than by banks nationally, and increases in the relative importance of problem loans that are not accruing interest.

Chart 2
Change in Net Interest Margin
(Using 1991 Q1 as the base period)



Nevertheless, California banks have been able to rebuild their capital positions. As with banks nationally this has been accomplished in part through retained earnings and raising new equity. But California banks as a group also improved their capital positions by reducing assets. In the first three quarters of 1992, California bank assets fell at a 3.9 percent annual rate, while nationally bank assets expanded at a 1.8 percent annual rate.

The combination of a smaller asset base and large increases in equity helped boost California banks' equity-to-assets ratio to 7.42 percent. Thus, California banks now slightly exceed the national average, which is the highest aggregate equity-to-assets ratio for the industry since the 1960s. This significant change in capital positions at California banks gives a strong signal that the state's banks are making progress despite lingering asset quality problems.

Gary C. Zimmerman
Economist

REGIONAL BANK DATA

SEPTEMBER 30, 1992

(NOT SEASONALLY ADJUSTED, PRELIMINARY DATA)

		DISTRICT	ALASKA	ARIZ.	CALIF.	HAWAII	IDAHO	NEVADA	OREGON	UTAH	WASH.
		ASSETS AND LIABILITIES -- $ MILLION (ALL COMMERCIAL BANKS)									
ASSETS	TOTAL	500,515	4,718	34,892	335,785	21,251	9,659	13,458	25,992	14,152	40,608
	FOREIGN (RESIDUAL)	29,789	1	0	27,759	1,917	0	0	0	66	46
	DOMESTIC	470,726	4,718	34,892	308,026	19,334	9,659	13,458	25,992	14,086	40,562
LOANS	TOTAL	341,146	2,168	19,399	235,125	13,547	6,789	7,466	17,835	8,607	30,211
	FOREIGN (RESIDUAL)	29,278	5	0	27,862	1,367	0	0	0	0	44
	DOMESTIC	311,869	2,163	19,399	207,263	12,180	6,789	7,466	17,835	8,607	30,167
	REAL ESTATE	166,986	934	6,987	123,373	7,037	2,078	2,616	7,233	3,374	13,354
	COMMERCIAL	63,565	739	2,567	41,042	3,170	1,545	863	4,548	1,591	7,498
	CONSUMER	55,101	346	5,644	28,899	1,139	1,885	3,761	3,624	3,005	6,798
	AGRICULTURE	5,839	4	378	2,767	55	845	16	480	151	1,142
	INTERNATIONAL	80	0	8	73	0	0	0	0	0	0
SECURITIES	TOTAL	64,514	2,007	7,682	34,418	4,179	1,751	3,099	4,042	3,224	4,113
	U.S.T.S.	20,948	863	2,555	10,142	1,995	394	1,714	1,191	681	1,412
	SECONDARY MARKET	31,972	599	4,362	18,545	1,639	834	958	1,925	1,734	1,376
	OTHER SEC.	11,594	545	765	5,731	545	522	426	926	808	1,325
LIABILITIES	TOTAL	460,996	4,102	31,859	310,858	19,695	8,929	11,875	23,681	12,910	37,089
	DOMESTIC	431,207	4,101	31,859	283,099	17,778	8,929	11,875	23,681	12,844	37,043
DEPOSITS	TOTAL	404,656	3,587	29,087	275,187	15,364	7,594	9,484	20,435	10,641	33,277
	FOREIGN (RESIDUAL)	28,211	0	0	26,499	1,592	0	0	0	66	54
	DOMESTIC	376,445	3,587	29,087	248,688	13,772	7,594	9,484	20,435	10,575	33,224
	DEMAND	89,323	1,073	5,324	63,124	2,194	1,339	2,385	4,048	2,117	7,718
	TIME AND SAVINGS	287,122	2,514	23,763	185,564	11,578	6,255	7,099	16,388	8,457	25,506
	NOW	39,837	334	3,179	24,020	1,456	960	1,193	3,111	1,432	4,152
	MMDA	94,054	540	7,302	66,238	2,001	1,476	2,380	4,413	1,829	7,875
	SAVINGS	43,143	661	3,313	26,814	2,874	832	1,528	2,081	1,416	3,625
	SMALL TIME	73,759	488	8,376	42,634	2,129	2,404	1,109	5,885	3,065	7,670
	LARGE TIME	36,011	455	1,592	25,648	3,115	583	886	892	712	2,128
OTHER BORROWINGS		33,088	476	2,242	16,433	3,695	1,225	1,532	2,630	2,009	2,847
EQUITY CAPITAL		39,519	617	3,033	24,927	1,557	730	1,583	2,312	1,242	3,519
LOAN LOSS RESERVE		10,422	41	553	7,806	227	104	363	461	203	664
LOAN COMMITTMENTS		193,734	580	26,904	123,678	5,977	2,566	1,771	9,661	6,375	16,223
LOANS SOLD		18,865	32	153	17,866	90	21	109	225	66	303
		EARNINGS AND RETURNS -- $ MILLION, YEAR-TO-DATE (ALL COMMERCIAL BANKS)									
INCOME	TOTAL	34,454	315	2,059	22,987	1,334	660	1,480	1,860	1,054	2,705
	INTEREST	27,159	258	1,619	18,013	1,189	568	1,064	1,449	858	2,140
	FEES & CHARGES	2,032	17	149	1,371	33	43	42	129	62	185
EXPENSES	TOTAL	29,522	228	1,918	20,248	1,044	520	1,096	1,482	824	2,162
	INTEREST	10,765	87	715	7,202	549	247	220	563	345	837
	SALARIES	6,544	69	451	4,499	238	93	133	391	151	519
	LOAN LOSS PROVISION	3,418	6	160	2,648	46	28	208	120	58	146
	OTHER	8,795	66	593	5,899	211	152	535	409	270	660
INCOME BEFORE TAXES		4,927	87	141	2,736	290	139	384	378	230	543
TAXES		1,984	26	64	1,222	105	49	131	131	76	179
NET INCOME		2,945	60	90	1,500	184	92	253	247	155	364
ROA (%)		0.79	1.72	0.34	0.60	1.16	1.24	2.43	1.27	1.49	1.20
ROE (%)		9.93	13.07	3.95	8.02	15.78	16.73	21.32	14.22	16.62	13.81
NET INTEREST MARGIN (%)		4.38	4.86	3.46	4.31	4.04	4.35	8.10	4.58	4.94	4.30
		ASSET QUALITY -- PERCENT OF LOANS (LARGE COMMERCIAL BANKS)									
LOAN LOSS RESERVE (ALL BANKS)		3.06	1.90	2.85	3.32	1.67	1.53	4.86	2.58	2.36	2.20
NET CHARGEOFFS, TOTAL		1.15	0.23	1.32	1.27	0.22	0.33	3.80	0.91	0.58	0.45
	REAL ESTATE	0.82	0.08	1.21	0.99	0.06	0.08	0.36	0.40	0.34	0.05
	COMMERCIAL	1.02	0.32	2.68	1.06	0.32	0.47	0.68	1.50	0.63	0.50
	CONSUMER	3.15	0.48	1.88	4.01	0.91	0.53	6.82	1.41	1.80	1.12
	AGRICULTURE	0.31	0.00	1.23	0.18	1.34	0.41	0.00	0.09	0.83	0.20
PAST DUE & NON-ACCRUAL, TOTAL		6.09	4.05	4.24	7.16	2.59	2.07	6.39	3.15	2.77	4.15
	REAL ESTATE	7.67	4.88	6.44	8.66	2.76	2.73	6.23	3.76	3.82	6.38
	CONSTRUCTION	19.71	13.59	18.98	21.02	9.04	8.06	16.05	9.58	9.20	20.12
	COMMERCIAL	8.15	5.14	9.61	9.72	0.94	2.62	4.57	4.85	3.41	4.15
	FARM	6.71	0.00	27.32	6.97	9.94	5.61	0.00	0.87	4.46	2.56
	1-4 FAMILY REV	1.36	0.50	0.85	1.49	1.33	0.74	0.67	0.21	1.13	0.91
	1-4 FAMILY OTHER	2.78	1.83	2.70	3.06	2.85	1.64	2.51	1.33	1.73	1.30
	MULTI-FAMILY	6.81	1.77	12.71	8.17	0.44	1.23	14.68	1.32	0.65	0.50
	COMMERCIAL	6.49	3.50	8.23	7.52	2.89	2.45	8.11	3.46	3.88	3.01
	CONSUMER	3.26	2.32	2.59	3.88	2.51	1.48	6.32	1.44	1.59	1.59
	AGRICULTURE	6.15	0.00	6.50	8.72	1.09	1.94	4.10	4.78	3.60	3.05
NUMBER OF BANKS		753	8	38	457	17	20	18	48	54	93
NUMBER OF EMPLOYEES		245,563	2,597	19,145	161,029	8,351	4,802	5,951	15,882	7,215	20,591

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MARKET SHARE STATISTICS

DEPOSITORY INSTITUTIONS REQUIRED TO HOLD RESERVES WITH THE FEDERAL RESERVE ON A WEEKLY BASIS

PERCENT OF COMBINED MARKET TOTAL FOR NOVEMBER 1992, BY REGION

	DISTRICT			ALASKA			ARIZONA			CALIF			HAWAII			IDAHO			NEVADA			OREGON			UTAH			WASH		
DEPOSIT TYPE	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU	CB	SL	CU
TOTAL DEPOSITS	55	39	6	71	4	25	93	0	7	48	46	6	67	28	5	91	5	4	73	24	3	81	10	9	77	8	15	57	34	9
DEMAND	91	5	5	99	0	1	96	0	4	90	5	5	89	3	8	95	0	5	97	3	0	94	1	4	89	5	6	89	8	3
NOW	64	28	8	59	6	35	89	0	10	58	36	7	65	32	3	92	3	4	78	16	6	84	8	8	82	3	15	65	24	11
SAVINGS & MMDAS	60	32	8	56	4	40	90	0	9	56	37	7	61	33	6	92	4	5	80	15	5	78	10	13	70	6	24	58	26	16
SMALL TIME	32	64	3	75	9	16	95	1	4	24	73	3	51	47	2	88	10	1	42	54	3	77	17	6	77	15	7	40	56	4
LARGE TIME	46	45	9	94	2	4	94	0	5	40	50	10	80	16	4	89	6	5	62	37	0	75	11	14	69	11	19	47	51	2

CB = COMMERCIAL BANKS; SL = SAVINGS & LOANS AND SAVING BANKS; CU = CREDIT UNIONS; MAY NOT SUM TO 100% DUE TO ROUNDING

INTEREST RATES ON DEPOSITS AND LOANS AS OF NOVEMBER 1992 (%)

TYPE OF ACCOUNT OR LOAN		DATE	US	DISTRICT	ARIZ	CALIF	HAWAII	IDAHO	OREGON	UTAH	WASH
SAVINGS ACCOUNTS AND MMDAS		SEP92	3.00	3.11	2.71	2.97	3.26	3.54	3.02	3.25	3.34
		OCT92	2.94	3.05	2.64	2.81	3.26	3.50	2.94	3.23	3.27
		NOV92	2.90	3.05	2.65	2.79	3.26	3.50	2.94	3.23	3.25
92 TO 182 DAYS CERTIFICATES		SEP92	3.16	3.17	2.94	3.04	3.05	3.26	3.15	3.28	3.53
		OCT92	3.11	3.15	2.88	2.91	3.05	3.20	3.13	3.25	3.51
		NOV92	3.14	3.14	2.88	2.90	3.05	3.20	3.11	3.25	3.49
2-1/2 YEARS AND OVER CERTIFICATES		SEP92	4.62	4.52	4.22	3.93	4.44	5.10	5.03	4.65	4.78
		OCT92	4.60	4.50	4.11	4.06	4.61	5.10	4.84	4.60	4.59
		NOV92	4.70	4.56	4.11	4.02	4.36	5.11	5.74	4.61	4.60
COMMERCIAL, SHORT TERM*	AVE. RATE		4.99	6.43	6.75	6.71	6.88	8.07	6.41	5.36	5.44
	AVE. MAT. (DAYS)		57	128	N/A	127	91	N/A	56	144	37
COMMERCIAL, LONG-TERM*	AVE. RATE		6.36	7.13	N/A	8.16	8.44	N/A	N/A	6.71	7.15
	AVE. MAT. (MONTHS)		48	29	N/A	42	44	N/A	N/A	23	39
LOANS TO FARMERS*	AVE. RATE		7.45	6.89	7.04	6.78	N/A	7.56	7.04	4.61	7.20
	AVE. MAT. (MONTHS)		11	13	N/A	15	N/A	N/A	N/A	7	N/A
CONSUMER, AUTOMOBILE	AVE. RATE		8.60	8.76	9.90	8.11	N/A	10.50	7.50	9.40	8.99
CONSUMER, PERSONAL	AVE. RATE		13.55	12.83	14.80	13.37	N/A	10.50	10.52	13.13	12.48
CONSUMER, CREDIT CARDS	AVE. RATE		17.39	18.29	17.90	18.98	N/A	N/A	19.25	17.90	18.30

SOURCES: SURVEY OF TERMS OF BANK LENDING AND TERMS OF CONSUMER CREDIT; MOST COMMON INTEREST RATES ON SELECTED ACCOUNTS.

* DATA ARE COMPOUNDED ANNUAL RATES.